

Financial Related Audit  
City of Detroit  
**FINANCE DEPARTMENT**  
**INCOME TAX DIVISION**  
April 2001

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CONTENTS

	<u>Page</u>
LETTER OF TRANSMITTAL	1
AUDIT PURPOSE, OBJECTIVES, SCOPE, AND METHODOLOGY	2
DESCRIPTION OF AGENCY	4
INCOME TAX DIVISION'S GOALS AND OBJECTIVES	5
FINDINGS AND RECOMMENDATIONS	
*1. Need to Process City Income Tax Refunds on a Timely Basis	6
*2. Need for Adequate Segregation of Duties for Cancellation of Assessments	6
*3. Need to Assess Taxpayers Who Fail to Comply with the Estimated Tax Provisions of the Income Tax Ordinance	7
*4. Need to Substantiate Reported Withholding Amounts	8
5. Need for Implementing and Updating Procedures to Identify Non-filers	8

DEPARTMENT'S RESPONSES

ATTACHMENT

\* This finding appeared in the previous Auditor General report.



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CITY OF DETROIT

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June 14, 2001

J. Edward Hannan, Director  
Finance Department  
1200 Coleman A. Young Municipal Center  
Detroit, Michigan 48226

Dear Mr. Hannan:

As authorized by the City Charter, we performed a financial related audit of the Finance Department's Income Tax Division of the City of Detroit.

As a result of our audit, we submit this report for your consideration. This report contains our audit purpose, objectives, scope, and methodology; a description of the agency; the Division's goals and objectives; our audit findings and recommendations; and the Finance Department's responses to our recommendations.

While the recommendations on internal control procedures as included in this report are not intended to be all inclusive, the correction of all or any number of conditions as recommended would tend to strengthen the controls in effect.

Responsibility for the installation and maintenance of a system of internal control that minimizes errors and provides reasonable safeguards rests entirely with the Finance Department. Responsibility for monitoring the implementation of recommendations is set forth in section 4-205 of the City Charter which states in part: "Recommendations which are not put into effect by the agency shall be reviewed by the Finance Director who shall advise the Auditor General and the City Council of the action being taken with respect to the recommendations."

We appreciate the cooperation of the officials and employees of the Income Tax Division extended to us during the audit.

Sincerely,

Joseph L. Harris  
Auditor General

## **AUDIT PURPOSE, OBJECTIVES, SCOPE, AND METHODOLOGY**

### **Audit Purpose**

This audit was performed as part of our Charter mandate to make audits of the financial transactions of all City agencies. The audit report is intended to provide recommendations, which if implemented by the Income Tax Division would achieve improved internal controls and increase municipal income tax revenue collections.

### **Audit Objectives**

Our financial related audit of the Income Tax Division of the Finance Department had the following objectives:

1. To assess the Division's internal controls relating to:
  - Reliability and integrity of information;
  - Safeguarding of assets; and
  - Compliance with policies, plans, procedures, laws, and regulations.
2. To evaluate the methods and controls in place to achieve the Division's objective of maximizing revenue.
3. To determine the status of prior audit findings.

### **Audit Scope**

We reviewed and tested the system of internal accounting controls, selected income tax returns, and selected income tax processing activities of the Income Tax Division for the purposes indicated above.

Our audit focused on the Division's efforts to maximize City income tax revenue. It did not cover all aspects of the Division's financial operations, such as the handling of Utility Users Tax revenue or the computerized Tax Administration System. Based on auditor's judgement, we examined a relatively small sample of tax returns filed for the calendar years 1997 and 1998, and income tax related transactions, in comparison to the population.

Our audit was conducted in accordance with the Government Auditing Standards issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

### **Audit Methodology**

To accomplish our audit objectives, our audit methodology included the following:

- We reviewed various reference materials (e.g., the Division's Procedures for Return Processing) to obtain background information about the Income Tax Division.
- We interviewed appropriate personnel to gain an understanding of the methods and procedures used by the Division to process income tax returns, identify non-filers, approve and process assessments, and perform other functions.
- We examined a judgmental sample of tax returns to determine that the tax was properly computed, the returns were checked for completeness, and the information on the return was properly entered into the computerized data files.
- We performed an analysis to identify risk factors which could prevent the Division from achieving its objectives, and assessed the Division's controls and procedures for maximizing revenue.
- We evaluated the Department's practices for identifying non-filers.
- We identified specific criteria, including the Division's objective of maximizing revenue, generally recognized principles of internal control, the State law (P.A. 198 of 1991) related to payment of interest on refunds, and the City's income tax ordinance.

## DESCRIPTION OF AGENCY

Finance Director: J. Edward Hannan  
Division Head: Loretta Neal, Income Tax Director

### Budgeted Appropriations:

1999-2000	\$ 5,325,021
1998-1999	\$ 4,938,543

### Staffing Levels:

	<u>Regular Employees</u>	<u>Contractual Employees</u>	<u>Total</u>
June 30, 2000	78	-	78
June 30, 1999	78	-	78

The Income Tax Division of the Finance Department is primarily responsible for administering the City's Income Tax and Utility Users Tax.

The City derives its income taxing power from Michigan Public Act 284 of 1964, as amended, and adopted by the City under Ordinance 900-F. Public Act 284, as amended, provided that the City may levy a 3% income tax on resident individuals, a 2% income tax on corporate income earned within the City, and a 1 ½% income tax on nonresident individual income earned within the City, effective July 1, 1981. The Act also provides for the collection of estimated and withholding taxes.

An amendment to the Act provided that beginning July 1, 1999, the resident rate will be lowered by 1/10 of a percentage point each July 1 for the next ten years, until the rate is reduced to 2%. In addition, the nonresident rate will be 50% of the tax imposed on resident individuals for the same period until it is reduced to 1%, and the corporate tax rate will be reduced by 2/10 of a percentage point each year for the next ten years until it is eliminated.

The City derives its utility users taxing power from Michigan Public Act 198 of 1970 (the City Utility Users Tax Act), as amended. This Act allows the City to assess and collect up to a 5% tax on users in the City of Detroit for intrastate telephone services, electric, steam, and gas utilities.

State Public Act No. 548 of 1998 amended the Utility Users Tax Act to reduce the population threshold necessary to impose the City Utility Users Tax from 1,000,000 to 750,000 residents. This will ensure that the City of Detroit will be allowed to continue to assess the tax, even though the City's population has fallen below 1,000,000 residents based on the year 2000 census.

## **INCOME TAX DIVISION'S GOALS AND OBJECTIVES**

The goals and objectives of the Finance Department's Income Tax Division are as follows:

1. Maintain and enhance the fully Integrated Income and Utility Users Tax Administration System (TAS)
2. Continue to Improve Customer Services:
  - Electronic funds transfer of employer withholding payments
  - Electronic and telephone filing of income tax returns
  - Implementation of interactive voice system
3. Continue Outreach Programs:
  - Outreach programs for employers' withholding
  - Outreach programs to utility users for participation in MichCon collection programs
4. Enhance Income and Utility Users Tax Base:
  - Implementation of discovery and enforcement program for licenses in conjunction with the Buildings and Safety Engineering Department
5. Maximize Income Tax and Utility Users Tax Revenue:
  - Ongoing implementation of revenue and collection efforts in conjunction with IRS
    - ♣ Non-filer matching programs
    - ♣ Non-filer programs for adjusted federal returns
    - ♣ Joint training and coordination of revenue collection activities
  - Collection of court judgments and payment plans

## FINDINGS AND RECOMMENDATIONS

\*This finding and related recommendation appeared in the previous Auditor General report. The date shown indicates the audit report in which the finding and related recommendation or part thereof first appeared.

### **\*1. Need to Process City Income Tax Refunds on a Timely Basis:**

(June 30, 1992) Prior to January 1, 1993, Michigan cities which levied income taxes were not required to pay interest on taxpayers' refund claims, regardless of the amount of time it took to generate such refunds. However, effective for Tax Year 1992, an amendment was made to the State of Michigan's City Income Tax Act. This amendment requires municipalities that levy income taxes to pay interest upon valid taxpayer refund claims, when such refunds take more than forty-five (45) days to process from an established date.

We reviewed the Income Tax Division's ability to process refund tax returns within the time constraints imposed by the State's amended City Income Tax Act. We noted late refund payments to taxpayers resulted in the City incurring late payment interest costs of approximately \$256,000 and \$668,000 in the two fiscal years ended June 30, 1999 and June 30, 2000, respectively.

In addition, two objectives of the Income Tax Division are to improve customer service, and to maximize income tax revenue. To enable achievement of these objectives, the Income Tax Division should minimize delayed refund payments. The prompt processing of City Income Tax refund payments fosters maintaining or improving relationships with the taxpaying public, and increases net income tax revenue by decreasing the amount paid in interest payments.

According to Income Tax Division representatives, the goal of promptly processing all refunds is hampered by the volume of tax returns during peak periods, staff shortages, and taxpayer errors on returns.

**We recommend** the Income Tax Division implement procedures and secure resources, which enable it to process refunds on a timely basis.

### **\*2. Need for Adequate Segregation of Duties for Cancellation of Assessments:**

(June 30, 1992) The Finance Department's Income Tax Division generates various types of assessments. Following are some examples of situations where assessments are automatically prepared by the Tax Administration System (TAS):

- Assessments may be generated as a part of the Income Tax Division's review and audit of annual income tax returns (e.g., the auditor may determine that the taxpayer has additional income that should be taxed or the auditor may disallow a deduction).
- Assessments can result from taxpayer errors on the tax return; or the taxpayer may not submit payment with a tax return that shows a tax due; or the taxpayer submits a tax return with a Non-Sufficient Funds check.



- Assessments are generated for employers who owe money withheld from their employees for income taxes, but did not submit amounts withheld to the City.

During our review and test of assessments, we found that the Income Tax Division does not have adequate segregation of duties for the cancellation of assessments. The same individual who initiates cancellations also enters the data into the Tax Administration System (TAS).

A Departmental representative indicated this is attributable to inadequate staffing for assessment related operations.

An effective system of internal control includes procedures which provide adequate segregation of incompatible duties to safeguard assets.

**We recommend** the Income Tax Division take the action necessary to establish procedures to have an employee, other than the initiator of an assessment cancellation or their supervisor, enter the cancellation into the Tax Administration System.

### **\*3. Need to Assess Taxpayers Who Fail to Comply with the Estimated Tax Provisions of the Income Tax Ordinance:**

(June 30, 1992) Certain taxpayers are required to file a "Declaration of Estimated Tax" form and pay a minimum of 70% of their final tax by an established date. The City Income Tax Ordinance provides for the imposition of interest and penalty charges if the total amount of tax withheld and paid by declaration does not equal at least 70% of the total tax liability on the taxpayer's current return, or at least 70% of the total tax liability on the taxpayer's return for the preceding tax year.

Under the Tax Administration System (TAS), the Division has the ability to identify and assess taxpayers who have not complied with this requirement, but has not done so due to other priorities.

This function will be performed more efficiently and effectively, and result in increased revenue, if accomplished as a computer application of the TAS.

Since successful income tax collection efforts depend, to a certain extent, on the timely issuance of assessments, **we recommend** the Income Tax Division implement the TAS computer application, which will identify and assess, on a timely and automatic basis, interest and penalty charges to those taxpayers who are not in compliance with the estimated tax provisions of the City Income Tax Ordinance.

#### **\*4. Need to Substantiate Reported Withholding Amounts:**

(June 30, 1988) Our review of the Income Tax Division's ability to monitor employers' withholding of City income taxes from employees' earnings disclosed that withholding credits taken on taxpayers' (the employees) returns are not matched against the corresponding amounts withheld and/or remitted by employers, as documented by records which employers submit to the Income Tax Division.

No effective means for improving internal control and maximizing income tax revenue by isolating problems and discrepancies related to withholding, such as identifying non-filing taxpayers and non-filing employers, is utilized.

Division representatives indicated the reason the Income Tax Division has not implemented such a process is that there is no applicable computer program under the Tax Administration System (TAS) to perform this function.

A satisfactory system of internal control includes methods and measures for providing effective accounting control over revenues such as comparing withholding amounts on various records which are available to the Income Tax Division.

To strengthen internal control over amounts withheld for municipal income taxes, and to identify both non-filing employees and employers and determine the extent of such non-filing, **we recommend** the Income Tax Division implement procedures to systematically match amounts of withholding credits taken on taxpayers' (employees) returns to the corresponding amounts reported as withheld by employers, and vice versa, on a sample basis.

#### **5. Need for Implementing and Updating Procedures to Identify Non-Filers:**

The Income Tax Division has established a program with the Internal Revenue Service (IRS) which enables it to match City residents who filed a Federal income tax return with those who filed a City income tax return. Under this program, the IRS provided the City with a computer tape of Detroit residents who filed a Federal return. However, the Income Tax Division has not utilized this program since 1995 for 1993 tax returns. The Department has recently met with the IRS to attempt to reinstate this practice and expand its scope to include nonresidents, as well as residents.

The Income Tax Division also used to compare State of Michigan income tax records (provided on a computer tape) to the City's income tax records to identify non-filers, but no longer does so. A representative indicated that the Division discontinued this practice in 1993 because the Federal income tax return contains more information pertaining to taxable income.

By not comparing City income tax records to IRS and State income tax records, the Division is missing an opportunity to identify non-filers and maximize income tax revenue. Making comparisons to IRS records and to State records would enable the Income Tax Division to determine and identify persons who filed a Federal or State return, but did not file a City return. Then, based on the number of non-filers and potential municipal income tax revenue identified by this process, the Income Tax Division could determine what specific action to take.

An effective system of internal control includes methods and measures for providing effective accounting control over revenues, such as procedures to identify non-filers by comparing City income tax records to State records and to Federal records on a more timely basis, as a method to identify and collect all potential revenues.

**We recommend** the Income Tax Division take the action necessary to compare IRS and State of Michigan records to City income tax records to identify non-filers, thereby helping assure maximization of municipal income tax revenue and compliance with the City's income tax code.



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## ATTACHMENT

June 8, 2001

Joseph L. Harris  
Auditor General, City of Detroit  
Suite 208  
Coleman A. Young Municipal Center  
Detroit, Michigan 48226

Dear Mr. Harris

The following presents the Finance Department's responses for each indicated finding and related recommendation included in the April 2001 Financial Related Audit report of the Finance Department's Income Tax Division, as prepared by the Office of the Auditor General.

Finding No. 1 – Need to Process City Income Tax Refunds on a Timely Basis:

We recommend the Income Tax Division implement procedures and secure resources, which enable it to process refunds on a timely basis.

Department's Response

The Income Tax Division's analysis of its return processing operations for the past two years identified errors on taxpayers' returns (i.e., refund amount on balance due line) and staffing turnover as the primary causes for delays. Additionally, refunds can be delayed as a result of audits, taxpayer response time to requests for additional information, etc. Revised processes and procedures have been implemented to identify and resolve many common errors prior to processing taxpayers' returns. Additionally, enhancements to TAS have been implemented.

Finding No. 2 – Need for Adequate Segregation of Duties for Cancellation of Assessments:

We recommend the Income Tax Division take the action necessary to establish procedures to have an employee, other than the initiator of an assessment cancellation or their supervisor, enter the cancellation into the Tax Administration System.

Department's Response

The Income Tax Division is revising its assessment cancellation procedures to insure adequate segregation of duties. The Tax Administration System (TAS) has similar safeguards in use on the refund approval. The volume of assessment cancellations warrants an electronic review. The Batch Write Off/Abatement Activity Report will segregate cancellation duties by adding administrator's oversight to all activity.

Finding No. 3 – Need to Assess Taxpayers Who Fail to Comply with the Estimated Tax Provisions of the Income Tax Ordinance:

We recommend the Income Tax Division implement the TAS computer application, which will identify and assess, on a timely and automatic basis, interest and penalty charges to those taxpayers who are not in compliance with the estimated tax provisions of the City Income Tax Ordinance.

June 8, 2001

DENNIS W. ARCHER, MAYOR

Department's Response

We concur with the recommendation. To effectively implement this function a prior year return must be on file in TAS. The earliest opportunity was in calendar year 2000. However, due to limited resources efforts were concentrated on migrating TAS to our in-house system. Efforts are underway to activate this function of TAS.

Finding No. 4 – Need to Substantiate Reported Withholding Amounts:

We recommend the Income Tax Division implement procedures to systematically match amounts of withholding credits taken on taxpayers' (employees) returns to the corresponding amounts reported as withheld by employers and vice versa, on a sample basis.

Department's Response

During the procurement process for TAS, we found there were no income tax systems capable of systematically matching employees' withholding credits to amounts withheld by employers. Currently, there are over 16,000 registered employers and approximately one million W2s received annually. This matching process is further compounded by the Income Tax Act that allows taxpayers up to four years to file for income tax refunds. For example, the statute of limitations for filing 1997 refunds does not expire until April 30, 2002. A massive manual effort would be required to reconcile employee withholding credits to withholding amounts reported by employers for any given calendar tax year. Discussions are ongoing with the IRS and other governmental entities regarding the feasibility of this process.

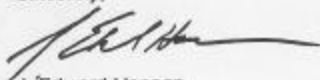
Finding No. 5 – Need for Implementing and Updating Procedures to Identify Non-Filers:

We recommend the Income Tax Division take the action necessary to compare IRS and State of Michigan records to City income tax records to identify non-filers, thereby helping assure maximization of municipal income tax revenue and compliance with the City's income tax code.

Department's Response

During the period of 1997-2000 an outside collection agency was hired to identify potential individual and employer non-filers. This contract expired in June 2000. The non-filer matching programs with IRS requires annual system modifications due to changes in basic tax forms each year as well as the impact of new legislation. Prior matching programs were performed in a mainframe environment. TAS was migrated to a client/server environment in October 2000. Efforts are underway to modify IRS matching programs to run on the City's UNIX Oracle platform. We met with IRS representatives who will assist us in expanding the scope of employer information matching programs.

Sincerely,



J. Edward Hannan  
Finance Director

JEH/LPN:yg

cc: Loretta P. Neal  
Income Tax Director